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UNCLAS SECTION 01 OF 03 SAO PAULO 000590

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SUBJECT: GLOBAL FINANCIAL CRISIS HITS BRAZIL'S ENERGY SECTOR

REF: A. 07 SAO PAULO 0953; B. RIO DE JANEIRO 0302

SENSITIVE BUT UNCLASSIFIED--PLEASE PROTECT ACCORDINGLY

¶1. (U) Summary: The lack of credit worldwide has hit Brazil's energy sector. Despite the recent discoveries of billions of barrels of oil reserves below Brazil's seafloor, Brazil faces an increasingly uphill battle to turn the government's energy rhetoric into reality. Estimates range that it will cost USD 300 to 600 billion to commercialize the country's offshore reserves of oil and gas, money that Petrobras does not have. Industry analysts estimate that Petrobras would need to tap financial markets for up to USD 30 billion over the next few years. At a minimum, delays to the initial six year timeline are expected. In addition, the credit crunch has hit the ethanol and sugar industry. The shortage of short-term financing has delayed capital goods improvements and construction of new sugar mills, causing potentially 40 to 50 million tons of sugarcane to remain unused this harvest. Finally, a lack of infrastructure financing might delay big energy projects down the line. Given the wealth of natural resources and diversity of its energy supply, Brazil will probably fare better than many emerging market peers over the medium-term. The goal of becoming more energy self-sufficient, however, could face more delays. Brazil may take longer to reduce its dependence on Bolivia for natural gas. End Summary.

Pre-Salt Woes

¶2. (U) President Lula has touted the discovery of billions of barrels of oil and gas reserves in the so-called pre-salt layer 185 miles off Brazil's coastline as "a gift from God" and has pledged to use resulting revenues to end poverty and narrow the country's income gap. But before rhetoric becomes reality, Brazil must first get to the underwater reserves, located more than a mile below the ocean's surface and under another 2.5 miles of earth and corrosive salt. The cost of drilling and gathering the oil is high, largely because salt beds can break loose and fracture pipes, making it one of the toughest substances to drill. Similarly, the logistics of getting the oil and gas to shore for domestic use require the construction of an extensive network of new infrastructure projects and massive investments.

¶3. (SBU) The pre-salt oil fields will be the most complicated and

costly projects that Petrobras has ever carried out. Analysts currently estimate they will cost between USD 300 to 600 billion over the next 30 years, and from USD 25 to 80 per barrel. Most, however, concede that future costs cannot be defined with certainty in the current economic environment. The more companies that drill test wells in the pre-salt area, the less expensive the exploration process will be as they learn more about how to drill through the salt layer. (Note: Sao Paulo State Federation of Industries (FIESP) energy experts told Econoff that they estimated the costs somewhere between USD 70 to 80 per barrel. Petrobras officials told Rio Econoff that pre-salt extraction costs are approximately USD 25 to 28 per barrel; however, none of Rio Econoff's other energy contacts believe the Petrobras estimates. They say they are too low. End Note.)

¶4. (SBU) The global financial crisis has dampened the prospects for the potential windfall below Brazil's seafloor. The falling world oil price and global credit crunch will likely extend the investment horizon for many of those fields. Credit Suisse estimated that Petrobras would have to invest USD 50 billion to exploit the pre-salt oil fields, build new refineries, and cover additional costs from 2008 to 2012. Even if Petrobras can sell oil at USD 80 per barrel, Credit Suisse projected that Petrobras' cash flow would not be enough to meet the investment required and would need extra funding of at least USD 30 billion.

¶5. (SBU) Former Valor Economico senior editor Carlos Eduardo Lins da Silva told the Consul General he believed the worldwide credit crunch probably would extend the pre-salt production timeline. He estimated that the Tupi field, for example, would take some 20 years to develop given financing constraints of Petrobras' suppliers and

delays to energy infrastructure. (Note: When Petrobras first announced Tupi in November 2007, the production timeline was closer to five to six years. See Ref A for more on that discovery. End Note.) Petrobras put off announcing its new investment plan to analyze the influence of the international financial crisis and has also signaled it could postpone the deadline for proposals for exploration of the pre-salt oil (Ref B).

Ethanol Industry Suffering

¶6. (SBU) The Senior Technology and Development Vice President at Dedini Jose Luiz Oliverio, the world leader in sugar mill equipment, told Econoff that the sector was in a terrible crisis. He noted that the Brazilian National Development Bank (BNDES) had been late in delivering financing for project expansion which many customers had planned to use to purchase Dedini products. As a result, Oliverio said Dedini's best customers had fallen behind on payments and many customers had already started delaying orders for new equipment and upgrades.

¶7. (SBU) The Brazilian Sugarcane Industry Association (UNICA) President Marcos Jank underscored that sugar and ethanol prices had been low over the last few years and were now expected to climb due to market demand in an interview with Folha de Sao Paulo. He pointed to the credit crunch as their biggest concern because many mills are heavily leveraged. Jank was in Brasilia October 30 lobbying the GOB for a loan package of R$14 billion to support the industry. UNICA's Public Relations Manager Carolina Costa told Econoff that the sector was in limbo, waiting to see how much the crisis would affect the ethanol and sugar industries. She noted that many members had delayed longer-term project plans due to the lack of credit; however, short and medium term projects had for the most part already locked-in financing and she said UNICA did not believe they would be affected.

¶8. (SBU) As the Brazilian sugarcane harvest comes to a close (April to November), post notes that some 40 to 50 million tons of sugarcane would be left in the field if the rainy season started in November (per normal weather patterns). Last April and May were very wet months and many mills had delayed the planting cycle. In addition, sugarcane farmers had anticipated that a number of new mills would come online to crush the additional sugarcane, but many

have been delayed because of financing constraints and due to backlogs in capital goods production. Post ATO expects the impact from the credit crunch to filter through the sugar and ethanol industries quicker than most because of the strong fundamentals for the sector.

Infrastructure Delays

¶9. (U) According to the Brazilian Association for Infrastructure and Structural Industries (ABDIB), Brazil has 324 large infrastructure projects already under construction or approved that are in serious risk of delays because of the lack of available financing. Of the R$ 90 billion still unfinanced, R$ 82 billion (approximately USD 39 billion) would go to infrastructure projects in the energy sector. Electrobras, a state-run electricity producer, in October suspended a USD 400 million international bond emission that it needed to finance the group's investments, including the construction of the two Rio Madeira generation projects and the third nuclear power plant at Angra. The GOB announced on October 21 that it was delaying the auction for building the USD 3.5 billion Rio Madeira high-tension power line stretching from the Amazon Basin to the outskirts of Sao Paulo. Though not specifically citing the crisis as the reason in that case, many economists have pointed to its potential impact on infrastructure investments. Despite the GOB's explicit claims of protecting the Growth Acceleration Program (PAC), Brazil has historically cut infrastructure project financing in economic downturns.

Comment

¶10. (SBU) The short-term implications of the credit crunch for Brazil's energy sector have already started eating into the bottom line. Over the medium-term, however, Brazil will probably fare better than most emerging markets. With a wealth of technology in deep-sea drilling and the cheapest feedstock in the world for ethanol distillation, Brazil will remain an important bioenergy player. Delays in development of the large natural gas reserves in the pre-salt layer, however, will leave Brazil dependent on imports of Bolivian natural gas in the short-term. Likewise, ethanol producers probably will delay retrofits to increase efficiency for additional bioelectricity production, given current financing constraints. With the promise of great oil finds off the Brazilian coast, President Lula had begun discussing, and many Brazilians had begun to expect, great investments in education and social equality. These dreams may have to be put on hold given the effects of the current global economic slowdown. End Comment.

¶11. (U) This cable was coordinated/cleared by Embassy Brasilia and by the ATO in Sao Paulo.

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